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Point/Counterpoint: Will Credit Card Legislation Curtail Consumer Credit?

The U.S. **Senate** *votes Tuesday on credit-card legislation that would impose new requirements for fees, disclosures and interest-rate changes on consumers. Proponents say it will end unfair and confusing practices. The industry warns that the changes would cut some consumers' access to credit cards and raise interest rates even for reliable customers. Would it be bad for the economy if the new legislation limited credit to some consumers? Real Time Economics asked* **Mark Calabria** *of the* **Cato Institute** *and* **Kathleen Keest** *of the* **Center for Responsible Lending** *to make their arguments:*

Mark Calabria, director of **Financial Regulation Studies** *at the Cato Institute think tank, says government limits on credit cards harm consumers and the economy:*

The most basic function of all financial transactions is to allow households to more closely align their lifetime flows of consumption and income. While the most important mismatch between desired consumption and income happens over the life-cycle – workers earn less at the beginnings and ends of their lives than in the middle – shifting income from good economic times to bad also improves household welfare.

Credit cards have been an essential element of these efforts. Credit cards allow the un- or under-employed to spend now out of future expected income. To limit credit solely to the financially stable leaves those most in need outside of our formal financial system, instead forcing such households to borrow from less efficient, and often more costly, sources, such as friends and family, or pawn-shops and loan sharks. The trend in recent months of households shifting away from mortgage debt to credit card debt has been essential in allowing households to maintain spending in the face of declining home values – absent such spending our economy would be in worse shape.

Of course, financial contracts are like any other form of contract – should they be unconscionable, fraudulent or lacking in consideration – they should not be enforced by courts. And that decision should be judged by courts on an individual basis – and not driven by politics.

As credit risks in the economy change, so should credit pricing. While we want credit to be widely available, that credit should be accurately priced – to provide the right incentives for borrowers and lenders alike. Practices such as universal default – where credit card rates are raised upon the default of other loans – provides for a more accurate pricing of risk. Someone defaulting on their car loan is undoubtedly a higher risk to their credit card company than someone making their car loan. If we've learned anything, it should be that in times of stress, risks across various kinds of credit become more highly correlated.

Kathleen Keest, senior policy counsel at the nonprofit Center for Responsible Lending, formerly served as an assistant attorney general in Iowa and as a credit specialist with the **National Consumer Law Center***. She says clearer ground rules and more affordable credit products will help the economy:*

"Would it be bad for the economy if the new legislation limited credit to some consumers?" This question rests on two unfounded premises. The first is that the new legislation would limit credit. The second is that less credit would mean less demand for goods and services, which would put a damper on an economic recovery. Neither is true.

We're nearly a year into an historic credit contraction, one that's re-taught us a painful lesson. Sound, common-sense oversight doesn't constrain credit, lack of it does. That's because lack of oversight begets loans that borrowers cannot afford to pay, which causes losses to financial institutions and a lack of investor confidence. Investors no longer trust the lenders to know what they are doing because in fact lenders did not know what they were doing. That loss of trust and confidence has limited credit. Setting some simple ground rules that move the credit market toward products that are suitable and affordable for consumers is the way to re-build confidence and thaw the economy.

Equally simplistic – and misdirected — is the notion that more debt is required to encourage more demand. Americans have lost confidence in their financial future, and too many households are grappling with too much overpriced and risky debt. Credit card penalty rates, for example, can double the rate on existing balances and can be imposed for almost any reason, even if the cardholder hasn't violated the contract. We recently calculated that one year in the "penalty box" for an average revolving line of credit costs around $1,800 per year. That's money that cannot be spent in the real economy. The credit card reform bill being debated in the Senate would limit card issuers' ability to apply such rates retroactively and would ensure that being sent to the "penalty box" wasn't a life sentence.

The current business model of maximizing revenue in the short term is not working well because it's pushing more credit card customers over the edge. It's certainly not good for consumers. And it's not good for the economy, because access to more unsafe, unsound and uncertain debt is not what American households need to encourage them to face their financial future with confidence. Worse still is that abusive lending practices often end up in the taxpayers' lap, as the mortgage crisis illustrates. Who benefits when companies have to take massive losses on unsustainable loans? No one.